The Neglected Role of Justification Under Conditions of Uncertainty

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The Neglected Role of Justification Under Conditions of Uncertainty

 

By Claire A. Hill and Alessio M. Pacces March 12, 2019

A hot topic in corporate governance is the so-called short-termism of publicly held companies. In response to actual and anticipated pressure from activist hedge funds, companies are, some say, focusing too much on short-term gains by, for instance, shunning research and development. This behavior undermines long-term value at the expense of shareholders and society, the argument goes. The opposing view is that the pressure to perform is necessary to keep management on its toes. Both camps seem to have a point.

In our recent paper, we argue that whether short-termism is a problem in general is impossible to determine. Because the right time horizon for a company is not known, managers who bemoan short-termism might actually suffer from long-termism, postponing the realization that better times will never come. However, hedge fund activism creates a short-term bias because of the need for relevant actors, including management, to justify their decisions. The impact of activist hedge funds on companies depends on the extent to which management has to justify its decisions to investors. This turns on corporate law's balance between managerial discretion and accountability. This short-term bias cannot be efficient for every company at all times. Companies should be able to choose how to balance managerial discretion and accountability and to alter their choices over time. We argue that dual-class shares are the right legal tool to enable this choice.

We introduce a novel conceptual framework. We define justification cost as the cost of suboptimal managerial choices resulting from accountability. Accountability prompts managers to act with a view to justifying their decisions. Managerial action that can be justified tends to be more conventional, yield results that are demonstrable in the short term, or both. The need for justification reduces the traditional agency cost of monitoring the agent, because conduct such as tunnelling or empire building is harder to justify. But the most justifiable actions may not always be those that are best for shareholders. Actions chosen because they are justifiable may limit an agent's downside risk: Underperformance can then be attributed to bad luck. Managers may be tempted to make decisions they can justify, whether or not those decisions are best for the shareholders. The result is that justification may also increase agency costs. We call this form of agency cost "justification cost" to distinguish it from traditional agency cost. On this perspective, accountability becomes excessive when it increases justification cost more than it decreases traditional agency cost.

Justification cost rises, and thus is likelier to exceed traditional agency cost, in contexts of high uncertainty. In the presence of Knightian uncertainty – the lack of any quantifiable knowledge about a possible occurrence – agents find justification comparatively more difficult because actions cannot be based on broadly accepted probability distributions or other conventional wisdom. Therefore, accountability prompts agents to avoid uncertainty. It encourages pursuit of short-term results (outcome accountability) or failing those, defensible procedures for decision-making (process accountability). Although proceeding in this way is beneficial for purposes of accountability, it is costly to the extent that avoiding uncertainty implies refraining from being entrepreneurial in corporate governance. Lack of entrepreneurship may be harmful for shareholders and for society at large.

In our framework, the efficient balance between managerial discretion and accountability varies with a particular company's exposure to uncertainty. Although every managerial decision involves some uncertainty, in some situations the uncertainty is relatively small. Sometimes justification-minded actions are the best agents can do to pursue the principal's interest. Think for example of companies that have excess cash and use it to engage in acquisitions without a clear business purpose; justification rightly curbs such behavior. Another example is where vigorous competition requires a company to react quickly; short-term feedback may be the only way for the company to remain competitive. But sometimes conventional actions, and a focus on short-term results, lead to the neglect of long-term profit opportunities. This may be value-destroying in industries where innovation is discontinuous rather than incremental– that is, where uncertainty is high. Note that the relevance of uncertainty in particular industries changes over time. For instance, the future of the automotive industry is highly uncertain today, something that was arguably not the case 20 years ago.

Thus, short-term bias, whether or not stemming from hedge fund activism, is efficient in contexts of vigorous competition and incremental innovation, but may be inefficient when uncertainty is higher, for instance in situations of discontinuous or radical innovation. It is argued that because hedge fund activists must garner institutional investors' support to be successful, those investors would remedy this bias, going along with the activists only when doing so is efficient. However, while the empirical evidence is weak on this point, theory suggests that institutional investors' screening is not reliable. Because the portfolios of the majority of institutional investors are indexed, institutional investors do not have incentives to screen idiosyncratic choices. Moreover, institutional investors have to justify their actions too, which reinforces short-term bias. Another way to tilt the balance toward discretion and away from accountability is through controlling shareholders. Although the vast majority of listed companies around the world have dominant shareholders, those shareholders do not always control enough votes to fend off activists. As a result, the controller's decisions and strategies may be challenged by activist minority shareholders, especially in Europe, where minority-shareholder rights have grown over the past two decades.

We argue that corporate law should enable companies to choose and fine tune the balance between managerial discretion and accountability. We expect that they may do so particularly when they face higher uncertainty. The most straightforward legal tool to affect this balance is dual-class shares, which allow voting rights and cash flow rights to be disproportionate. Management can secure leeway with super-voting shares that allow it to outvote other shareholders. This approach is increasingly common, especially for companies that have recently gone public. In the U.S., for instance, 10 percent of the companies whose stock trades on the major market indices have dual-class shares.

Securing leeway by introducing dual-class shares is much more complicated for companies that are already listed. Dual-class recapitalizations with super-voting stock are limited or even prohibited by exchange rules in the U.S. and are not a viable way to increase the voting rights of management or controlling shareholders in European jurisdictions.

We contend that companies that are already listed should be able to introduce control-enhancing mechanisms, such as dual-class shares, under the following rules. First, managers or controlling shareholders should be allowed to issue super-voting stock to themselves. Second, non-controlling shareholders – in practice, institutional investors – should have veto power over the introduction of control enhancement. In line with the Delaware Chancery Court's MFW decision, we would require a combination of independent advice from, say, a special committee, and a majority-of-the-minority (MOM) shareholder vote for effective cleansing of the resulting conflict of interest. Institutional investors' veto is crucial to enable a negotiation over the price of super-voting shares. This price would reveal how much leeway institutional investors are willing to give management. Third, the control enhancement should expire in a set number of years. The purpose of this default sunset clause, which companies could opt out of, is to avoid negotiation breakdown. When dual-class shares are established for an indefinite time, the price of the super-voting shares incorporates the value of control, which may be hard to agree upon for companies that are already public.

Our solution is preferable to other proposals for granting management more leeway. Curbing hedge fund activism across the board would go too far, precluding activism where it is efficient, particularly for companies that benefit from short-term feedback. A second alternative is loyalty shares. Although in theory loyalty shares are meant to support long-term ownership, in practice they have been used by controlling shareholders as a substitute for dual-class shares. The main disadvantage of loyalty shares from this perspective is that a controlling shareholder may introduce them unilaterally, i.e. without a MOM vote, which deprives institutional investors of an effective veto right on changing the distribution of power. Finally, our solution fares better than imposing mandatory sunset clauses on every dual-class share arrangement. Mandatory sunset clauses exclusively focus on how to discontinue dual-class shares when they have become inefficient. Our concern is broader: We worry also about how to introduce control enhancement when doing so is efficient. Allowing dual-class recapitalizations subject to a veto by institutional investors addresses both problems. It allows management to contract for leeway in midstream. It also provides as a default that dual class shares would be discontinued, but could be reintroduced if needed.

This post comes to us from professors Claire A. Hill at the University of Minnesota Law School and Alessio M. Pacces at Amsterdam Law School and Amsterdam Business School. It is based on their recent paper, "The Neglected Role of Justification Under Uncertainty in Corporate Governance and Finance," available here.